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# MAINTAINING STRONG FINANCIAL MANAGEMENT

The District is emerging from the control period with an opportunity for a fresh start. The government can prove not only that it has resolved long-standing financial problems but also that it can responsibly manage its own finances. During this period, the District has shown a budget surplus in four consecutive years, and its bond ratings have improved from junk-bond to investment-grade status. The District must now build on these accomplishments. Only if this challenge is met can the District's hopes for home rule be realized.

This chapter explains the background and solution to the District's financial plight, examines alternative approaches to financial planning, and reviews the opportunities and challenges that will affect future economic growth. In particular, the chapter:

- Describes the sunset of the control period, including how the District entered this period and steps it will take as it emerges;
- Explains in detail the various reserve funds that the District maintains;
- Describes tax expenditure programs and proposes guidelines for their use, in the context of a future budget for such programs (being developed this year on a pilot basis); and
- Analyzes the District's economic outlook and the likely consequences for the District's finances.

## **Sunset of the Control Period**

The District ran budget deficits in 1994, 1995, and 1996, and its bonds during that time period were graded at junk-bond levels. In short, the city had lost control of its finances. In response, in 1995, the U.S. Congress established the Financial Responsibility and Management Assistance Authority (the Financial Control Board) as well as a Chief Financial Officer (CFO) for the District, who was (and is) independent of the Mayor's office.

The situation in 2001 is vastly different. Independent auditors recently verified the city's fourth consecutive surplus, and the city's bonds have returned to investment-grade status. This turnabout has taken place as a result of more than five years of joint efforts by the Control Board, the CFO, the Mayor, the City Council, and the Congress.

### *The Control Period*

The financial problems that led to the imposition of the control period have been well documented. Some of the problems related to long-standing structural imbalances in the District's finances, and these imbalances persist in some cases. Others were the result of poor short-term decision-making and slow reactions to signals that a crisis was at hand.

At least as early as 1990, the warning signs of fiscal crisis were apparent. A November 1990 report<sup>1</sup> pointed out a number of structural problems with the city's finances along with more immediate causes, such as the then-current recession and high crime rates that were placing excessive demands on city services. Many of the structural problems related to the particular nature of the District-federal relationship, some of which are discussed in detail in Chapter 13. Others, however, such as population loss, related tax revenue loss, and high city government staffing levels, were problems that were common to many cities but that were unusually serious for the District.

Congress enacted the 1995 Fiscal Responsibility and Management Assistance Act following a large budget deficit in fiscal year 1994. The Act established the Control Board, which was charged with reviewing most legislation with major financial impact as well as decisions on contracts and other financial matters. In addition, responsibility for day-to-day operations of certain city agencies was taken from the Mayor and given to the Control Board.

A major restructuring of the responsibilities took place in 1997, which immediately improved the District's financial prospects. Under the National Capital Revitalization and Self-Government Improvement Act, the federal government assumed responsibility for several functions that are either:

- Traditional state functions (for example, certain judicial and corrections functions); or
- The legacy of federal control over the District's employment policies (for example, the accumulated unfunded pension liabilities for police officers, firefighters, judges, and teachers).

In exchange, the annual federal payment was eliminated, although federal contributions have been made in some succeeding years. In fiscal year 1997, the District posted its first surplus following three consecutive deficits.

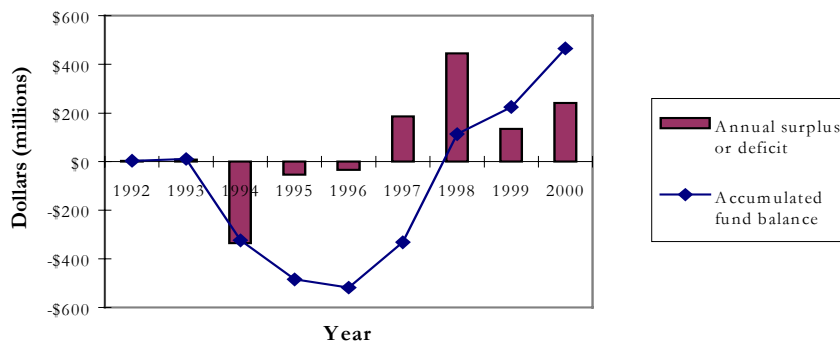
As the financial situation continued to improve, more management authority was returned to the District's elected leaders in 1999, when the Congress passed the District of Columbia Management Restoration Act. In addition, on-going improvements in a number of management functions have contributed greatly to the District's improved financial health. For example, major changes were made to the tax collection function that have enabled the city to collect a much greater share of the taxes due to it than had been occurring in the past.

The overall turnaround in the District's finances is illustrated by Figure 13.1, which shows annual deficits or surpluses as well as the accumulated general fund balance for each year since 1992.

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<sup>1</sup> Financing the Nation's Capital: The Report of the Commission on Budget and Financial Priorities of the District of Columbia, November 1990. This report is often referred to as the "Rivlin report" after the chair of the Commission, Alice Rivlin.

Figure 12-1  
District's Budget Surplus/Deficit and Accumulated Fund Balance, 1992-2000



### Emerging from the Control Period: The District's Plans for the Future

As it emerges from the control period, the District is committed to ensuring that any future financial problems will never again reach the crisis level they reached in 1995. To guard against this outcome, the District plans to (1) maintain certain reserve funds, (2) budget for certain items that may reduce tax revenues, and (3) continually analyze economic conditions that could threaten its long-term financial stability. (Each of these measures is discussed in a separate section in this chapter.)

To achieve its goal of maintaining financial stability, the District will also remain committed to balancing its annual budget. The primary way a city can demonstrate its ability to manage its finances is to submit and implement a balanced budget year after year. The budget submission for FY2002 represents a first step toward implementing performance-based budgeting and reflects policy decisions that were made to achieve another balanced budget. As a result of these policies, in the future, audits verifying balanced budgets will be a matter of routine rather than a noteworthy event.

The FY2002 financial plan anticipates revenues and expenditures growing at roughly equal rates over the next four years. Revenue trends and assumptions are detailed later in this chapter. For expenditures on wages, salaries, and fringe benefits, the financial plan assumes a growth rate of 3.3 percent--a 2.6 percent inflation rate for the Washington area plus an additional 0.7 percent growth over inflation to reflect other potential adjustments in compensation. For expenditures on nonpersonal services, such as utilities, supplies, and contracts, inflation of 2.6 percent per year is assumed in general. For certain specific programs, such as Medicaid, somewhat higher cost increases are expected.

For further details on revenue and expenditure projections and the anticipated net operating margin for FY2002 through FY2005, see the Financial Plan chapter of the FY2002 Proposed Operating Budget and Financial Plan.

## **New Structure for Financial Reserves**

The District is currently required to maintain three different reserve funds. Each year, the government must include in its budget \$150 million as a reserve fund for the current year. In addition, over the next seven years, the District must deposit one percent of the budgeted amount for the year into cash reserve funds—the first four percent into an emergency reserve fund, and the remaining three percent into a contingency reserve fund. Many state and local jurisdictions require reserves as a basic precaution against unanticipated financial problems. However, in contrast to these other jurisdictions, the demands placed on the District are high. Both the amount the District is required to set aside and the strict limits on the use of its reserves overly constrain its ability to respond to new challenges.

### *The \$150 Million Budget Reserve*

Section 148 of the District of Columbia Appropriations Act for FY2000 required the District to establish a \$150 million budget reserve. This reserve could only be expended according to criteria established by the CFO and approved by the Financial Management Authority. Pursuant to Section 148, the District's FY2000 budget included a \$150 million budget reserve.

The budget reserve requirement was continued in FY2001. Section 159 of the District of Columbia Appropriations Act for FY2001 contains an amendment to the District of Columbia Financial Responsibility and Management Act of 1995 requiring that, beginning with FY2000 and through FY2004, the District's budget must include a line item for the \$150 million budget reserve. To maintain the \$150 million balance, any amount expended from the reserve in any fiscal year must be replenished in the budget reserve for the subsequent fiscal year. Pursuant to Section 159, the District's budget for FY2001 contains this \$150 million budget reserve.

The \$150 million in appropriated reserve funds are non-lapsing funds that will remain available until they are spent.

### *Conditions for Use of the Budget Reserve*

The District of Columbia Appropriations Act for FY2001 provides the conditions under which the District can gain access to the \$150 million budget reserve:

- The reserve may only be used for nonrecurring and unanticipated expenditures.
- No funds may be used until all other surplus funds have been used.
- The reserve may not be used to assist court-ordered receiverships.
- The reserve may not be used to fund projected shortfalls in the reductions that are budgeted as savings initiatives in the District's proposed budget.

Once the above conditions have been met, the District must notify the Financial Authority of its intent to use the reserve funds. In turn, the Financial Authority must provide written notification of the District's intent to both the Senate and House Appropriations Committees 30 days in advance of any expenditure of the reserve funds.

### *The Four-Percent Emergency (Cash) Reserve Fund*

Section 159 of the District of Columbia Appropriations Act for FY2001 provides for the establishment and maintenance of an emergency cash reserve fund equaling four percent of the total budget appropriated for operating expenditures through FY2004. In order to build up the fund, the District must annually deposit one percent of local operating expenditures, approximately \$33 million in FY2001, and it must subsequently deposit an additional one percent in each of the following three fiscal years.

In addition to the above requirement for the District to make minimum deposits into the emergency reserve fund, the law also requires the District to deposit 100 percent of the debt service savings from tobacco securitization if the fund has not reached its four-percent goal. The District estimates that it will deposit \$69 million dollars of such savings in FY2001.

Interest earned from the emergency reserve fund remains in the fund and can only be withdrawn for unanticipated and nonrecurring extraordinary needs to cover emergency situations.

### *Conditions for Use of the Emergency Reserve Fund*

The Chief Financial Officer of the District, in consultation with the Mayor, must develop a policy to govern the emergency reserve fund. This policy must include language guaranteeing the use of the emergency reserve fund for unanticipated and nonrecurring extraordinary needs, such as a natural disaster or calamity. The emergency reserve fund may also be used if the Mayor declares a state of emergency, pursuant to Section 5 of the District of Columbia Public Emergency Act of 1980. The fund may not be used for the following:

- To finance any department, agency, or office of the District government that is administered by a receiver or other court-appointed official;
- To cover shortfalls in any projected budget reductions; and
- To pay settlements and judgments made by and against the District of Columbia.

The Mayor, the City Council, and, in the case of a fiscal year in which the Control Board has authority over the District's finances, the Financial Authority must notify the Senate and House Appropriations Committees in writing not more than 30 days after any part of the emergency reserve funds has been expended.

### *The Contingency (Cash) Reserve Fund*

Section 159 of the District of Columbia Appropriations Act for FY2001 provides for the establishment of a contingency reserve fund. In accordance with Section 159, the District must build and maintain a cash reserve equaling three percent of the total budget appropriated for operating expenditures by FY2007. The District will begin establishing the fund in FY2005.

Each year the District is required to deposit one percent of local annual operating expenditures into the reserve fund. In addition, interest savings achieved through tobacco securitization must go into the contingency reserve fund if the emergency reserve fund is at

four percent but the contingency reserve fund has not yet reached its three-percent goal. By law, the interest earned on the contingency reserve fund will remain in the account.

*Conditions for Use of the Contingency Reserve Fund*

The District of Columbia Appropriations Act for FY2001 spells out the conditions under which the contingency reserve fund may be used:

- It may be used only for nonrecurring needs that arise during the fiscal year, including (1) expenses associated with unforeseen weather conditions or other natural disasters, (2) unexpected liability created by federal law dealing with new public safety requirements that have been identified after the budget process has been completed, and (3) opportunities to achieve cost savings.
- It may be used, if needed, to cover any revenue shortfalls that occur for three consecutive months (based on a two-month rolling average) and are five percent or more below the District's budget forecast.
- It may also be used to fund shortfalls in any projected budget reductions included in the District's budget proposal for the fiscal year.

Under any of the circumstances listed, funds may be allocated only after the Chief Financial Officer prepares an analysis. In addition, all other surplus funds available to the District must have been completely exhausted. Moreover, the expended funds must be put back into the contingency reserve fund the following fiscal year.

*Elimination of Some Restrictions on the Use of Reserve Funds*

FY2001 is the second fiscal year in which the District has been required to maintain a \$150 million budget reserve. Despite the strain on the District's finances, establishment of a budget reserve is a generally accepted financial management policy.

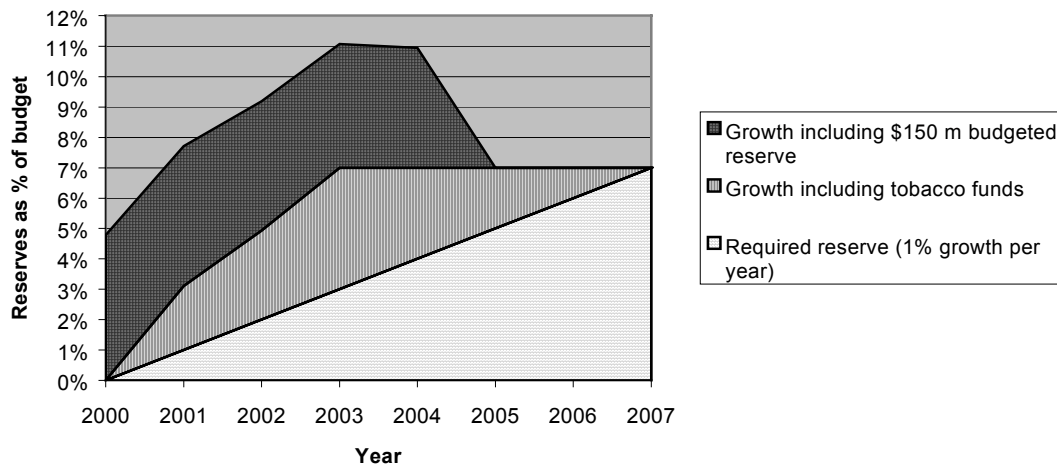
FY2001 is the first fiscal year in which the District has been required to establish the emergency and contingency cash reserve funds. Requiring the District to reach seven percent of the city's total budget appropriated for operating expenditures by FY2007 means that the government must set aside no less than one percent of operating expenditures each year. The seven-percent reserve requirement is more conservative than the five-percent reserve that 33 of 38 states set aside for unexpected cash needs. Furthermore, the seven-percent figure is also more conservative than the five-percent benchmark that financial markets use to support better bond ratings. Again, a cash reserve is a common feature of municipal government financial policies.

However, the combination of the required budget and cash reserves results in a large proportion of the District's resources to which it does not have access. In addition, the cash reserves will in fact grow much faster than originally anticipated. Therefore, rather than taking seven years to reach seven percent of the budget, these funds will attain that goal after only three years. The first deposit into the emergency cash reserve was made in October 2000, for \$32.5 million, one percent of the local fund operating budget for 2001. In addition, tobacco funds totaling \$68.5 million will be deposited into this fund in the spring of 2001. The fund will thus have an amount equal to 3.1 percent of the budget by the end of

FY2001. In FY2002, a one-percent deposit of about \$35.3 million, plus additional tobacco revenue of another \$34.9 million, together mean the fund will stand at 4.9 percent of budget--in fact, fully populating the emergency cash reserve at four percent and beginning to populate the contingency cash reserve. Finally, in FY2003, a one-percent deposit plus most of that year's additional tobacco money will bring the balance to seven percent of budget in the two funds combined.

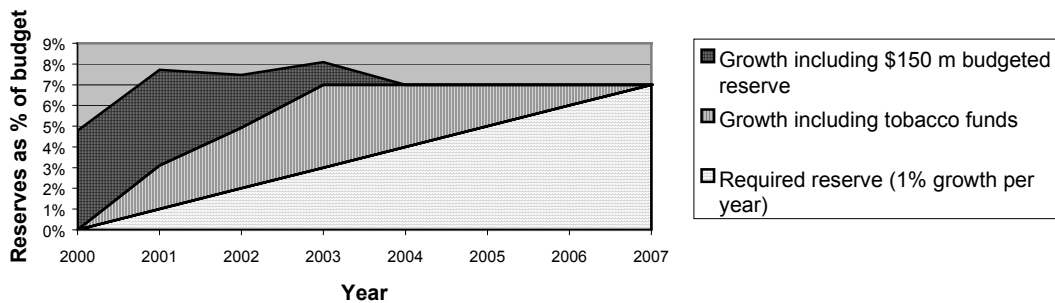
While the budget reserve is conceptually different from the cash reserve, adding \$150 million to the amount in the cash reserve each year is useful in demonstrating the size of required reserves relative to the District's operating budget. As figure 13.2 shows, the combination of these reserves means that the total reserve amount will be over 9 percent of the District's budget in FY2002 and 11 percent in FY2003--far more than most jurisdictions require.

Figure 12-2  
Projected Growth of the District's Reserve Funds



Given the cumulative effects of restrictions on use of the District's own funds, some relief may be warranted--either from the \$150 million budget requirement or from the requirement that all tobacco funds be deposited into cash reserves until they reach 7 percent. One way to accomplish this would be to phase out the requirement for the \$150 million budget reserve before fiscal year 2005. For example, reducing the requirement to \$90 million in FY2002, to \$40 million in FY2003, and to zero in FY2004--one year ahead of schedule--would still leave the District with over seven percent in reserve (budget plus cash) in each of those years, as figure 13.3 demonstrates. In addition, this would allow the District more control over its own funds and more flexibility to respond to important budgetary needs.

Figure 12-3  
Projected Growth of the District's Reserve Funds with Early Phaseout of the \$150 Million Budget Reserve



## Tax Expenditures for Economic Development

In addition to spending appropriated dollars on programs, a government "spends" dollars when it awards a tax abatement or reduction for any reason. Just as traditional spending programs can be compared on the basis of costs, tax credit policies can be compared on the basis of how much they "cost"—that is, the amount of tax revenue forgone. Similarly, just as governments budget for spending programs to ensure overall spending does not exceed revenues, a total tax credit or tax expenditure budget could be created to ensure tax breaks granted do not exceed a certain amount. As the District expands tax credits for economic development, such a budget would allow analysts to see what resources are devoted to this purpose.

The District is developing a pilot "tax expenditure budget" for FY2002. As it proceeds, it is considering utilizing the following policies to guide the awarding of economic development tax credits within such a budget:

- Allow tax credits only for taxes directly paid by the business. Do not allow credits for taxes that pass through the business, such as withholding tax for the employees and sales & use tax collected on products sold by the business. These pass through monies represent tax obligations of other parties and have no direct cost bearing on the business.
- Allocate the tax expenditures to start-up costs wherever possible. The goal is to reduce cost barriers to getting a business started. Examples include:
  - Investment tax credits against district income and franchise taxes;
  - Sales tax credits on construction costs and initial capital purchases; and
  - Waiver of deed recordation and/or transfer taxes.
- Credits against personal property tax, franchise tax, and sales & use tax paid by the business are likely to be good investments by the District, since these taxes may interfere with business decisions.
- If a business owns the property it occupies, then real property tax credits can be used. If the business is a tenant, executing a real property tax credit is much more difficult and is



not a preferred way to allow credit. Consider “incubators” or other options for tenants. If a tenant should be given a real property tax credit, use a voucher approach where the landlord receives the voucher as part payment of rent and the voucher can only be used to defray District real property tax.

- Permit a business to carry forward credits for a fixed period. Do not allow an open-ended period as this imposes unmanageable administrative problems and is a de facto, long-term subsidy.
- Do not allow carryback of credits. Carryback involves a direct outlay from the District’s budget (a refund) and these past taxes are not the issue in developing or retaining a current business.
- Avoid long-term subsidy of any project. Once a project is up and operating, it ought to be expected to hold its own. If it can’t, providing an on-going tax subsidy is comparable to taking revenue from schools, public safety, health care, or other critical public services. If an entire industry is unable to operate in the District, then the Mayor and Council could evaluate a tax rate reduction for the whole industry – but this generally would not be sufficient to overcome serious obstacles.
- Do not eliminate all tax liability for any project. Every project imposes some public service cost on the District. Every business citizen should participate to some degree in the cost of these services.
- In allocating tax credits, keep in mind the “shelf” problem where a business will face a sudden increase in tax when the credit runs out and this business is assessed tax at the same rates as all other businesses. A business may come back for more credit, arguing that the “shelf” is too high. To avoid on-going tax subsidies, find ways to minimize this problem from the beginning.
- Remember that other businesses are watching and wanting the same tax breaks too. Since the District cannot provide the same credit to everyone, the criteria for receiving a credit ought to be very clear and publicly articulated.
  - For example, a sales tax credit for equipment purchases and a five-year, phased-out personal property tax credit could be used to establish a technology-based start-up company. The rationale is that these businesses have to make heavy investment in this equipment and the first five years are critical to the business success.
  - Another example is to allow a five-year, phased-out real property tax credit for large floor space retail of certain kinds (perhaps clothing, if attracting clothing shoppers is deemed critical to other development efforts). The rationale is that the building height limitation in the city makes it difficult for retail to compete with other property uses for the comparatively scarce space available. A real property tax credit would ease some of the extra cost due to space limitations.

Utilizing principles such as these will ensure that scarce resources are targeted appropriately and that tax credit decisions, like spending decisions, are made by fully considering all possible alternatives.

## **The District's Economy in 2001**

The District's economy completed four straight years of modest, but solid, economic growth by the end of FY2000. Its economic assets as a place to both live and work expanded during this period. For example, the latest Census information suggests that the city's population loss since 1990 is at least ten percent less than estimated. The real estate market is booming and retail sales and employment are both up. In addition, various new initiatives put forth by local leadership are reshaping the city's image and generating new enthusiasm about the nation's capital. Fueled by the economy and improved tax administration, tax revenues have been growing, though most recently at a somewhat slower pace than economic activity.

The outlook for FY2001 to FY2005 is for continued modest real economic growth coupled with a continued increase in revenue collections. The economic assets of the District will continue to grow and the fiscal health of the District will continue to improve.

That is the good news; there are reasons for caution concerning this outlook, however. The District is vulnerable to national economic changes such as rising interest rates that affect consumer spending for travel, automobiles, housing, and other big ticket items. Regionally, as the District economy becomes more competitive it also will face stronger challenges from neighboring rivals. And locally, continued recovery of the District's public service delivery system is critical to sustaining economic growth.

Perhaps an even more important reason for caution is that the District's tax system does a poor job of harnessing its economic activity to generate increased revenues. District taxes often do not capture important areas of economic growth. A part of the problem is that the District can only tax about one-third of the income produced within its boundaries. In addition, the tax structure has not kept pace with the changes in technology that are driving economic growth. Finally, some of the District's taxes are simply unstable revenue sources.

### *The Economic and Revenue Outlook*

Gazing into the economic future is difficult under the best of circumstances. Doing so for a city surrounded by rapidly growing suburbs dependent on high tech dot-coms is downright treacherous. As a part of the region, the District is becoming a more and more attractive place to live and work. About three years ago, a booming national economy brought new economic opportunities to the District. At the same time, new leadership in the District rekindled faith in the District as a place to live, to work, and to earn a positive return on investment. Crime is down. Schools are improving, even if more slowly than some would like. The city is receiving national attention as a top place to enjoy urban life.<sup>2</sup> In addition, traffic congestion in the suburbs is making it more and more difficult to get from place to place. The District's economy is poised to carry the momentum of the recent past into the next several years with continuing moderate growth of employment and economic activity.

The District is growing, but the areas of strength in the economy are only weakly connected to the District's tax base, suggesting trouble meeting revenue needs over the long-term. This section reviews the facts, identifies some of the most important economic assets of the

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<sup>2</sup> In its 2000 survey, Fortune magazine ranks the Washington Metro Area as the fourth best city in the country for doing business.

District and reviews some of the imbalance between the District's tax system and its economic activity.

- Jobs located in the District are increasing and the economic base of the District is changing. Fueled by strong job growth in the private sector, jobs in the District increased in FY2000 for the first time since FY1990. Along with the growth the job mix has changed. The economic base of the District is shifting toward the service sector. From FY1997 to FY2000, the service sector added 11,000 wage and salary jobs, while the government sector lost 12,000 jobs.<sup>3</sup>
- The District's real personal income and gross state product (GSP) continue to grow. Although modest compared to the blistering growth in its suburbs and the U.S. as a whole, real personal income and GSP grew at a healthy rate of 2.4 to 3.1 percent per year between FY1997 and FY2000.<sup>4</sup>
- More District residents now have jobs. Resident employment in the District increased in FY1998 for the first time in eight years. Between FY1990 and FY1997, the number of employed District residents fell by 22 percent; however, from FY1997 to FY1999 the number of working residents increased by 26,000 persons, about 11 percent, lowering the unemployment rate and pushing up the labor participation rate. The average unemployment rate in 2000 was 5.6 percent. Although high compared to a 2.3 percent unemployment rate in the Washington Metro Area, it is the District's best performance since 1989.
- Population decline has slowed; population stability is within reach if it has not already occurred. Population decline continues to taper off as people find more reasons to be city residents. A better economy, better services, lower crime rate, and shorter commutes are all important reasons. The estimated decline of 2,400 in total population from 1998 to 1999 was the lowest in 12 years. The latest population count of 572,059 is about ten percent higher than the previous Census estimate for 1999, suggesting that a turn-around in population loss might already be under way.
- More income taxpayers are moving into than out of the District. In 1999, 123 more taxpayers moved into the District from another U.S. jurisdiction than moved out (unfortunately, the number of exemptions leaving the city still exceeds the number coming in). In 1996, the number moving out exceeded the number moving in by 5,200.
- The District is attracting more income tax filers in upper income brackets. The number of tax filers making more than \$100,000 and making between \$50,000-\$100,000 increased by 2,000 per year for each income class between 1995 and 1998. Meanwhile, families making less than \$20,000 decreased 3,700 per year during the same period.
- Office space is increasing and the vacancy rate is low. The Class A office vacancy rate at the end of 2000 was 3.7 percent, the lowest in the region. New office space is being developed. More than two million square feet of space for lease was added in fiscal year 2000. Over four million square feet of space is currently under construction or renovation.

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<sup>3</sup> The number is based on the BLS's ES-202 data, which covers about 92 percent of total civilian wage and salary employment in the District. The increase in total wage and salary employment in service sector based on the BEA data between 1997-1999 is 20,000.

<sup>4</sup> These numbers are based on DRI's quarterly estimates for real GSP and personal income.

- Housing markets are strong. Demand for housing in the District is strong. In 1999, single-family housing starts and existing home sales both surged to their highest levels in recent memory. Strong demand, coupled with a shortage of single-family homes for sale, has resulted in significant price appreciation. In fiscal year 2000, single-family housing sales were up 12.5 percent and average prices increased 8.9 percent over FY1999.

In addition to these facts, anecdotal evidence suggests a very healthy economic outlook for the District. The number of construction cranes is virtually growing across the city. The hotel industry is thriving with about one percent growth in rooms and two percent growth in demand annually. Commercial development in downtown remains strong with over four million additional square feet to come on line. This new space is 70 percent leased and is to be delivered by 2003.

While the retail sector is already thriving, District residents have the income to support even more retail sales. Substantial buying power in the District leaks into the shopping malls and other retail locations in surrounding jurisdictions. No wonder the District's retail sector is significantly smaller than that of the typical U.S. jurisdiction.

Per capita income in the District is about 40 percent above the national average. With this substantial additional spending power, the District residents could support a larger-than-average retail sector, reaching into all neighborhoods. Successfully establishing this retail would have many additional benefits, such as encouraging population stability among pre- and post-middle age singles and couples. These groups typically are concerned with retail and recreational activities as amenities in their choice of location.

A larger retail sector also would increase the multipliers arising from other economic activity in the District. These multipliers summarize the extra economic benefit from a new job or investment. For the District, these extra economic benefits are quite small because new investment spending quickly dissipates into suburban households and shopping. For example, employees of a new business will spend little of their new income in the city and, instead, go just a few Metro stops away to a mall in Maryland or Virginia. The income and profits at the malls are likely to go to residents of other states, not back to District residents. By adding more retail to the District, we may garner more of these spin-off benefits back to the city.

### **Overcoming Obstacles to Increased Economic Opportunity**

The District's recent growth has already led to some problems. Lower-income families are having difficulty finding affordable housing. Higher-income families are simply bidding up the price of traditional affordable housing. Retail, offices, and hotels are all held back by the lack of a skilled workforce in the \$20,000 to \$40,000 per year income level.

Targeted policies to support education and training are important tools for overcoming these obstacles. The District will have to be very selective, however, and target employment policy to stimulate activities that would not otherwise occur on their own and are spurred by limited government support. Government resources are never sufficient to support all

possible claims for development while simultaneously providing the important services needed by residents.

Improving the training and marketable skill levels of District residents has substantial economic benefit. Whether by making the District more attractive for new residents with good skills, by increasing the skills of current residents, or both, the economic rewards for economic growth will be even greater. Higher skills will bring greater wage incomes and an even stronger retail base. Higher skills and incomes lead to more home ownership and a population more deeply invested in our community. Income tax and sales and use tax revenues could be stronger and more reliable, allowing for greater fiscal stability of the District's government.

### **Growth Potential of the District's Revenue System**

Growth of the economy may not be matched by growth of the District's tax stream. Even with the benefits of a stronger economy, the District government may struggle for financial stability. The apparent contradiction results from the real disconnection between the District's economy and its tax base. This section examines this dichotomy and identifies problems facing the long-term revenue base of the District of Columbia.

The outlook for sustained, long-term growth in the real value of the District's tax revenue is not good. This gloomy prospect stands in contrast to the possible growth of the District's economy. Economic rebound would bring more residents and higher wage earnings, adding to individual income tax revenue. Success in building the retail base of the District can lead to substantial growth in sales and use tax revenue. Yet, even if the District makes these gains, changes in eight other taxes are likely to dampen the purchasing power of total collections over the long-term. This conclusion is based on consideration of three tax bases at risk, five tax bases that cannot be counted on for sustained growth, and the two tax bases that may produce long-term strength.

#### *Tax Bases at Risk*

- **Toll telecommunications gross receipts tax and the public utilities gross receipts tax.** Competition and technology changes are creating alternatives to the local industries that provided these services in the last century. Increasingly, it will be impractical to tie provision of utility services to a location – a linkage necessary to impose the current gross receipts tax. For example, wireless phone service substitutes for wired local and long-distance service -- the wireless provider can be located virtually anywhere. These tax bases are at risk of dissipating over time.
- **Estate tax.** If the federal estate tax is limited or eliminated, the District's tax collections also will be limited or eliminated. Like many states, the District collects that part of the federal estate tax that is federally identified as apportionable to the local jurisdiction. When the federal tax changes, the District's will change correspondingly.

#### *Tax Bases That Are Unreliable For Long-Term Growth*

- **Corporate franchise tax.** The state-level corporate franchise tax can be managed by interstate corporations to decrease total tax burden. For example, corporations can use

tax planning to shift corporate costs into the District and corporate profits to states with a lower rate or no tax at all. For this reason, this revenue source is not likely to grow as fast as the national economy or as fast in the District as national business profits over the long-term.

- **Unincorporated business franchise tax.** Construction and Property Management are the two primary industries that pay the unincorporated business profits tax. (A Supreme Court decision found that professional service partnerships generally are exempt from this tax in the District, due to the home rule prohibition against taxing non-resident income.) Profits of these two industries are cyclical and will be constrained in the District because of limitations on space – both horizontally in land area and vertically in building height limitations. The District's land boundaries are very clearly drawn and there is very little vacant space. The limitation on building height means that, unlike other core cities, the District cannot “create” additional space by building higher structures. Because the competing suburbs have neither limitation, our neighbors will always have a competitive edge in this regard. Profits in both construction and property leasing are likely to have more dramatic swings in the District than in the suburbs and to have a lower long-term growth trend.
- **Real property tax.** The assessed value of the real property tax base changes rapidly in the District. In the boom of the late 1980s, property values and tax collections rose rapidly. This is happening again for FY2002. In the late 1990s, property values also grew rapidly, although assessed values for tax purposes were suppressed by the triennial assessment cycle. In the aftermath of the rapid growth of the late 1980s, assessed values and revenue fell very quickly in the early 1990s – faster than the general decline of the economy. Comparable declines in the future can easily be triggered for two basic reasons. First, an economic down cycle will affect rents and profits of property owners; assessments and revenue fall even more rapidly in the downturn than they increase in the up cycle, which will begin a phase-out in 2002 in favor of annual assessments. Second, even with a good general economy, property values can stagnate in the District due to greater competition from other metropolitan area locations. When the suburbs gain an advantage, property value quickly migrates out of the District into neighboring areas. And the suburbs will often have a competitive edge because of the District's limited land area and building height limitations.
- **Deed recordation and deed transfer taxes.** The same limitations facing real property and unincorporated business franchise taxes also affect the deed taxes. The District cannot add parcels by extending real property activity into new spaces. The potential volume of transactions subject to deed taxes is limited.
- **Individual income tax (capital gains revenue).** The recent boom in income tax revenue is substantially driven by capital gains (profits) that have been growing at rates unprecedented in history. The current slump in value of many previously fast-growing stocks illustrates that this cannot be sustained. Taxpayers will continue to have capital gains over the long-term, but these cannot be counted on as a source of accelerated long-term growth in inflation-adjusted revenue. Rapid, long-term growth in wage incomes, however, might be the source of long-term growth in real revenue from the income tax.

#### *Taxes with Long-Term Growth Potential*

- **Sales and use tax.** The Hotel and Restaurant components of the District's sales and use tax have the potential for continued real growth as the regional and national economies advance. Because a great deal of this revenue is generated from visitors, we can expect activity at least in keeping with external economic growth rates. The addition of the new convention center and related activities also may accelerate growth. The general retail sales component of this tax also has potential for growth, but only if efforts to stimulate development of the retail sector are successful. Because of the light density of retail currently in the District, much of the purchasing power of residents is used in other jurisdictions. If the District can attract successful retail activity over time, revenue will follow. Attracting this activity is made difficult by the abundance and variety of easily accessible shopping in the suburbs.
- **Individual income tax (Resident-earned income).** Incomes of residents are the basis of the District's individual income tax. Incomes generally consist of wages, profits (capital gains), rental income, and income supports such as social security, pensions, and "welfare" incomes. The District's potential for accelerated growth in income tax revenue requires accelerated growth in wages of residents. To achieve long-term growth in wages, at least one of two things must happen. One is consistent growth in new population with increasingly valuable and marketable skills – this way the District can import more and more income tax revenue over time. The second is for current District residents to achieve continuous improvement in the level and marketability of their skills. Successful and sustained policy efforts to improve the human capital of those who live in the city would be needed to secure this outcome.

The District cannot expect real growth in tax revenue from income supports unless some highly successful programs are implemented to attract a growing number of retired residents. Some jurisdictions have adopted policy programs to build a population of retirees, in part to gain the revenues linked to those drawing pensions and other retirement incomes. The District has not included this as one of its higher policy priorities, preferring instead to focus most policies on activities of greater benefit to current residents.

Because of the open nature of the District's economy, the impact of new business on the economy is small relative to that of other jurisdictions. Much of the new sales of both intermediate inputs and consumption commodities generated by the new business will go to those outside the District, which are often only a few subway stations away. Moreover, the impact on tax revenue is even smaller because only one-third of jobs in the District are filled by District residents, and nonresident income is not subject to taxation in the District. Signs of improving demographic trends, evidenced by the strong housing market and booming housing construction, are encouraging. However, as the population ages and the economy shifts more toward services, many of which are not subject to sales tax, securing more tax revenue will not be easy.

Table 12-1 summarizes the sources of the District's tax revenue by long term potential as well as the proportion of 1999 tax revenue coming from each source, and Table 12-2 shows certain elements of the District's tax base compared to neighboring jurisdictions.

Table 12-1  
Summary of Tax Revenue

	Tax year 1999	
	Dollars (000)	Percent of all taxes
<b>Tax Bases At Risk:</b>		
Toll Telecommunications	51,874	1.9
Public Utility	128,472	4.6
Estate	26,247	0.9
<b>Subtotal</b>	<b>206,593</b>	<b>7.4</b>
<b>Tax Bases Unreliable For Long-Term Growth:</b>		
Individual Income Remainder (includes capital gains)	253,503	9.1
Corporate Franchise	163,699	5.8
Unincorporated Business	53,896	1.9
Real Property	597,566	21.4
Deed Recordation	70,398	2.5
Deed Transfer	47,001	1.7
<b>Subtotal</b>	<b>1,186,063</b>	<b>42.4</b>
<b>Tax Bases With Potential For Long-Term Growth:</b>		
Sales and Use	594,804	21.3
Individual Income (withholding on earned income)	698,653	25.0
<b>Subtotal</b>	<b>1,293,457</b>	<b>46.3</b>
<b>Other Taxes:</b>		
Personal Property	73,928	2.6
Public Space	8,056	0.3
Insurance Premium	26,944	1.0
Economic Interests	3,687	0.1
<b>Subtotal</b>	<b>112,615</b>	<b>4.0</b>
<b>Total, all taxes</b>	<b>2,798,728</b>	<b>100.0</b>

Note: Figures may not sum to totals due to rounding.

Table 12-2  
Elements of the District's Tax Base Compared to Maryland, Virginia, and the United States, 1999

	DC	MD	VA	US Total
Employment income of residents as percentage of employment income earned in jurisdiction	33%	118%	106%	100%
Employment in sectors not subject to full taxation in the District* as percentage of total employment (for wage & salary workers)	60%	30%	28%	27%

\* Employment in hospitals, nursing & personal care facilities, education and social services, nonprofit organizations, federal, state and local government



## **Conclusion**

The District has enjoyed a great deal of success in recent years, and the economic forecast is reasonably optimistic. Population growth, improved employment data, and high per-capita incomes all augur well for maintaining and building on the financial gains the District has made. The financial plan anticipates a positive net operating margin for each of the next four years to follow the four consecutive surpluses the city has enjoyed.

Because of certain limitations in the District's revenue system, however, decision makers must remain vigilant to ensure these surpluses in fact continue. The District's economy as a whole is not fully reflected in its tax base, meaning that strong economic growth could be accompanied by somewhat lower revenue growth. With potentially growing demand for city services, a longer-term imbalance between expenditures and revenues remains a possibility.

The District is determined to sustain both economic growth and fiscal responsibility as it emerges from the control period. The Mayor, the Council, the CFO, and the Control Board have worked together to prove that the city can manage its finances well. As the control period sunsets, the city is well poised to more than adequately manage and sustain its financial health. Increased budgetary autonomy, as discussed in Chapter 12, and an adjustment to the required reserve structure would reward the District for its accomplishments to date and give it the flexibility to fully achieve this potential for the future.